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SUBJECT: INDUSTRY IMPLICATIONS OF THE REITS DEBATE IN GERMANY

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**¶1.** SUMMARY: Germany's Finance Ministry is nearing the completion of a draft law to legalize Real Estate Investment Trusts (REITs). The decision to legalize REITs, however, must first receive the approval of Chancellor Angela Merkel's "Coalition" Cabinet, which is deeply divided on the issue. While the Christian Democrats are in favor of REITs, some members of the Social Democrats have been actively publishing position papers and opinion articles in which they label REITs as "locusts" and dangerous for the German housing market. Industry experts believe that the legalization of REITs could reinvigorate Germany's currently sluggish, although potentially lucrative, real estate market (Germany's real estate market is valued at an estimated USD 9.5 trillion). The finance and investment industry is especially paying attention to the REITs debate, as experts believe its outcome could be an important indicator of how other finance-related legislation evolves. END SUMMARY.

REITS: TWO YEARS IN THE MAKING

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**¶2.** A REIT is a property investment fund that allows real estate holdings to be packaged as publicly traded companies that pay dividends from rent proceeds and property sales. The increased liquidity and transparency of being listed on a stock exchange is expected to attract a new class of investors, as well as more properties to the market. German proponents look to the success of the REITs model created by the United States in the 1960s and the experiences of several European countries that, according to a European Public Real Estate Association (EPRA) study, have REITs of their own (France, Italy, Spain, Belgium, the Netherlands, and, effective 1 January 2007, the UK). Finance Ministry officials claim that, if REITs are legalized in Germany, the market would be the largest in Europe; one estimate puts the potential market value of REITs in Germany at up to USD 290 billion. The Finance Ministry, which first organized a committee to discuss REITs in 2004, had hoped to introduce REITs into the market by 1 January 2006. Several firms, such as UBS, Morgan Stanley and Fortress, have already been preparing to offer German REITs in the expectation of its legalization, calling REITs "the hottest issue of 2006."

**¶3.** Political opposition to the introduction of REITs stems from a fear that foreign investors will descend on Germany like "locusts" and "prey" on the German real estate market in search of profits -- to the detriment of local residents and the federal government. (Note: The term "locusts" in reference to foreign investment companies was originally coined during the 2005 election cycle, when Social Democratic Party's former Chairman Franz Muentefering called foreign

private equity firms in Germany "locusts". The word has since been used not only to criticize the legislation introducing REITs but also to call for greater regulation of the hedge fund industry (reftel). End Note.) Under pressure from the new Left Party, members of the Social Democratic Party have taken the lead on criticizing the plans for legalizing REITs, raising the concern that REITs will increase the cost of rents to unaffordable levels and force middle-class residents to seek cheaper housing elsewhere. Even Chancellor Merkel has weighed in on the REITs debate, noting that the "social consequences" of REITs must be taken into consideration. Additionally, critics of REITs point to the potential losses the government will assume as a result of lost taxation revenue. With the on-going struggle to close financial holes in the budget, this argument has resonance in certain government circles. Through REITs, investment firms can avoid high corporate taxation rates by distributing all REITs profits to investors, who are then individually taxed at a lower rate. Critics have also pointed to the potential loss of government revenue as yet another example of how foreign investment firms are taking advantage of the German system.

¶4. Tensions within the "Grand Coalition" over the legalization of REITs escalated just before the beginning of its summer recess in June. After discussion in a Coalition working-group on the REITs issue, the group Chairman, Christian Democrat Leo Dautzenberg, announced that disagreements over the legalization of REITs had been resolved and that the Finance Ministry would begin drafting the REITs law. His statement provoked an angry response from SPD leaders that the group had not agreed on moving forward and claimed that critical obstacles to the legalization of REITs remained. Social Democrats went so far as to call

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Dautzenberg's announcement a "betrayal of trust" within the Grand Coalition.

REITs IN GERMANY: ILLUSORY OR SOON TO BE REAL?

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¶5. Embassy contacts at the Finance Ministry are hopeful of a successful legalization of REITs in Germany, although they acknowledge the political outcome is too uncertain to predict. If all goes according to the Finance Ministry's plan, the Coalition Cabinet will decide on the REITs draft law 20 September 2006, the Parliament will begin discussing it 19 October 2006, the Parliament's finance committee will give its opinion on the law 29 November 2006, and the Bundesrat will pass it 15 December 2006 so that the new legislation can come into effect in the first part of 2007. Coalition leaders and REITs advocacy groups, however, are doubtful that REITs will be legalized before the end of the year. Christian Democrats are supportive of the REITs legislation and note that their legalization is now dependent on whether Social Democrats decide to support REITs. Despite the Finance Ministry's concrete plans, Social Democrats in the Bundestag claim the REITs issue is currently at a "very vague state," making its future political direction difficult to assess.

¶6. Further complicating prospects for the legislation is the recent negative press given to high-profile American private equity firms investing in Germany's real estate market. In late July, German newspapers and magazines reported that a Texas-based private equity firm has been buying up mortgage debt in Dresden and hiking the interest rates to the point where families could no longer afford their monthly mortgage payments. Other critical news stories have emerged to tarnish the real estate investment industry. Finance Ministry State Secretary Thomas Mirow also noted at a German conference recently that REITs would inevitably suffer from an image problem in Germany because of the general public's deeply-rooted, cultural distrust of the finance and investment industry.

¶7. Industry experts are especially anxious about the outcome of the REITs debate in Parliament as the REITs draft bill is the first opportunity for the industry to determine the political parties' true positions on legislation for promoting Germany's financial industry. Industry experts hope that the introduction of REITs will be the first of several finance industry-friendly laws passed under Chancellor Merkel's watch. As early as this fall, the Finance Ministry plans to propose to Parliament a wholesale revision of the current investment laws in Germany, including current hedge fund regulation laws, with an eye toward reducing the regulatory burden on investment firms and fostering Germany's finance industry (reftel).

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